Taxation on the Sale of Farm Business Assets

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Factsheet

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INTRODUCTION

This Factsheet provides information to farmers who are considering the sale of their farming assets. It applies to sales to family members or strangers that occur at fair market value.

For information on transferring farm assets to family members where the assets are being sold for less than their fair market value, see the OMAFRA Factsheet *Taxation on the Transfer of Farm Business Assets to Family Members*, Order No. 03-023, and the *Farm Succession Planning Guide*, Publication 70.

This information is intended for planning purposes only. It does not replace professional advice from a tax specialist.

This Factsheet is divided into five sections.

Page 2 is a summary chart outlining the tax implications of selling farm assets.

SECTION 1: SALE OF INVENTORY ITEMS

The sale of inventories such as crops, supplies and livestock is included in income just as other product sales are. Farmers have the choice of reporting their income for tax purposes on either a cash or accrual basis[1].

Inventory Sales — Tax Filed on a Cash Basis

- If it is a cash sale, the proceeds are included in income in the year payment is received.
- If the inventory is exchanged for an open account or note, the amount owed for the inventory is an account receivable, and payments are included in income as they are received.

The following cash-basis deductions from income may be available when inventory is sold.

A basic herd deduction[2]

This deduction for mature animals owned prior to 1972 will likely have been fully used by most farmers, however, some may still have it available to them. Old tax files must be referenced to determine what the 1971 basic herd value was. If these are not available, the regional Canada Revenue Agency (CRA) office may be able to supply that information. The calculation is based on a per-animal basis. For instance, a dairyman with 30 basic herd units at $800 in 1971 would have a deduction of $24,000.

An optional inventory adjustment[3]

This inventory adjustment allows you to add a portion of your inventory value to your current year's revenue and then claim it as a deduction in the following year. This is useful if your current year's income is lower than normal and you wish to have some income taxed in the lower tax brackets. If income is higher the following year, you can use the deduction to reduce income and lower the tax paid. To determine if an optional inventory adjustment is available for the current year, see line 9941 of your Statement of Farming Activities, included with your previous year's income tax filing.

SUMMARY OF THE TAX IMPLICATIONS OF SELLING FARM ASSETS

Asset	Type of Income Sale Generates	How It Is Taxed	When Taxed	Options	Page Ref.
Inventory — cash basis	Farm income when payment received	Taxed at personal rate for sole proprietors, corporate rate for corporations.	In the year payment is received	Spread payment over several years by note or open account. Optional and mandatory inventory adjustments and basic herd deductions may be available.	1
Inventory — accrual basis	Farm income when sold	Same as above	In the year sold	Beginning inventory is a deduction in year of sale.	3
Machinery and equipment (Part XI) Post 1971	Possibly recapture of capital cost allowance, which is added to farm income. Possible capital gains	Recapture taxed at your personal rate. 50% of capital gains is added to income. No exemption available.	A reserve for recapture is not available; recapture is added to income in year of sale.	Replacement property rules can be used to defer recapture, in some cases. Consider timing of machinery sale. Consider deferring recapture by electing to move property from Classes 2 to 12 into Class 1 prior to sale.	7
Buildings (Part XI) Post-1971	Possibly recapture, which is added to farm income. Possible capital gains.	Recapture of CCA taxed at personal rate. 50% of capital gains is added to income. $750,000 capital gains exemption can be used if available.	Recapture is income in year of sale.	Capital losses can be deducted against capital gains. If a capital gains reserve is created, the gain can be spread over a maximum of 5 yr or 10 yr if sale to family member. Replacement property rules can be utilized.	7
Part XVII (pre-1972 assets) Machinery, equipment and buildings (straight line depreciation)	No recapture. Capital gains possible.	50% of capital gains is added to income. If available, $750,000 capital gains exemption used for buildings only.	Recapture of CCA and capital gains are income in year of sale for machinery and equipment.	For capital gains on buildings, a reserve could spread the gain over maximum of 5 yr, or 10 yr in sale to a family member.	8
Land	Capital gain	50% of capital gains is added to income. The $750,000 capital gains exemption can be used if available.	Taxable in year of sale	A capital gains reserve can be used to spread the gain over a maximum of 5 yr or 10 yr in the case of a sale to a family member. Replacement property rules can allow for the deferral of capital gain.	3–7
Quota (eligible capital property)	Recapture of CCA Quota can be taxed as a capital gain if a Section 14(1.01) election is filed or as business income that is eligible for the capital gain exemption if no election is filed.	See calculation and details of the ITA Section 14.01 on page 8.	Taxable in year of sale	The $750,000 capital gains exemption can be used, if available, as long as quota is owned for at least a 24-month period. Replacement property rules can be used to defer capital gains. A reserve is available for quota if an election is filed, however, Alternative Minimum Tax is payable on quota when the election is used.	8–9
House	Capital gain	Individuals are able to claim a principal residence exemption from capital gains.	Taxable in year of sale	Use the exemption or the optional method of reducing the total capital gain by $1,000 plus $1,000 per year of ownership for every year the house was the principal residence since 1971.	7

A mandatory inventory adjustment[4]

In the year a cash loss occurs, you must decrease the loss by the amount of inventory purchased that year that is still on hand at year end. This is called the Mandatory Inventory Adjustment (MIA), and its purpose is to prevent the creation of a loss by simply purchasing inventory. If you reported a mandatory inventory in the previous year, it can be deducted in the current year. To determine if a mandatory inventory adjustment is available, see line 9942 of your Statement of Farming Activities included with your previous year's income tax filing.

Inventory Sales — Tax Filed on an Accrual Basis

- The sale of inventory is considered income in the year sold, rather than when cash or payment is received. The beginning inventory is a deduction from income.
- If the beginning inventory's values are fairly current, the deduction should be large enough to minimize the tax consequences of sale of inventory.

SECTION 2: CAPITAL GAINS

Paying Tax on Capital Gains

Payment of income tax on capital gains began January 1, 1972, often called V-day (valuation day). Gains and losses are calculated on the difference in value between the adjusted cost base (ACB) and the sale price of capital property such as farmland, rental properties, stocks and personal property. Depreciable property, such as machinery, equipment and buildings, is subject to capital gains but cannot incur losses. For example, selling a machine for more than the original cost results in a capital gain. If it were sold for less, the loss on the sale is not deductible for tax purposes. The exception to this is when a complete class of assets is sold for less than the undepreciated capital cost balance in that class, resulting in a terminal loss (see section 3 for details).

Adjusted Cost Base

To calculate a capital gain or loss, you must know the adjusted cost base (ACB). This is the amount deducted from the selling price to determine a capital gain or loss. For property obtained before 1972, the ACB is the greater of original cost or the December 31, 1971, value. If obtained after 1971, the ACB is the purchase price plus costs. The cost base of land is adjusted by adding any non-depreciable capital improvements, legal and realty fees to the adjusted cost base. The ACB of buildings is increased by any capital improvements or additions, beyond just the normal maintenance and repair. An example of a capital gain calculation follows:

Table 1. Calculating capital gain

Purchased 1975	$150,000
Legal fees	1,000
Sold in 2008	600,000
Legal fees	2,000
Real estate fees	20,000
ACB = $150,000 + $1,000 + $2,000 + $20,000 =	$173,000
Capital gain: $600,000 – $173,000	**$427,000**

Taxation of Capital Gains

Fifty percent of a capital gain is tax free. The other half of a capital gain is subject to regular tax. This portion, called the taxable capital gain, is added to all other income in the year the gain occurs. Any allowable capital losses can be deducted from the taxable capital gain. If the capital gain occurs on a corporately owned asset, 50% of the gain is tax free and is allocated to the Capital Dividend Account. Dividends from this account are received tax free by the shareholder. The other half of the gain is taxable in the corporation.

The non-taxable portion of a capital gain may result in the application of the Alternative Minimum Tax (AMT) (see Section E). This is more likely to apply where the capital gains exemption is used.

Some tax credits may be affected in the current year and/or the year after reporting a capital gain even though the capital gains exemption is used. This is because the taxable capital gain is reported on your tax return and affects the calculations of tax credits even though the exemption is used to reduce the tax paid. The increased net income may result in the claw back of some benefits such as the Old Age Security and Child Tax Benefits in the current year and may also reduce them in the year following the capital gain.

$750,000 Capital Gains Exemption[5]

In 2007, the Capital Gains Exemption was increased from $500,000 to $750,000 for dispositions occurring after March 18, 2007. The $750,000 Capital Gains Exemption is available to individuals on the sale of qualified farm property. An individual, who used the entire $100,000 general exemption when it was eliminated in 1994, has $650,000 remaining. The exemption is also available to partners in a partnership,

since capital gains in a partnership flow directly to the partners who then can utilize the exemption. The capital gains exemption is not available to corporations; however, the shares of a family farm corporation are eligible for the exemption.

Qualified farm property[6] includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (see Section 4 on quota)

Equipment and machinery are not eligible for the capital gains exemption. However, in a partnership or corporation, the value of equipment and inventory is included in the corporate shares or partnership interest.

Qualified farm property must meet the following definitions:[7]

- Property must be principally used in farming by one of the following qualified users:
  - the individual
  - the spouse, child or parent of the individual
  - or by a family farm partnership or corporation of the individual, spouse, child or parent **and**

- Property purchased **prior to June 18, 1987**:
  - must be used in farming at the time of sale or
  - have been principally used in farming for any 5 years during its ownership

- Property purchased **after June 17, 1987**:
  - must be owned for 24 months prior to the sale

    and
  - in at least 2 years, the gross farm revenue of one of the qualified users who is actively engaged in farming the property must exceed income from all other sources

    or
  - the property was principally used by a family farm partnership or corporation in a 2-year period, during which time the individual, spouse, child, parent or partnership of which they are a member was actively involved in the farming business.

In all cases, the qualifying individuals, whether farming as a sole proprietorship, a partnership or corporation, must be actively engaged in management and/or the day-to-day activities of the business.

What Does "Principally Used" Mean?

From the previous section, it is clear the term "principally used" is an important factor in determining what qualified farm property is. The term unfortunately is not defined in the *Income Tax Act*. However, CRA has said that for administrative purposes, it means "more than 50%," both from a time perspective and a usage point of view. For example if a farm building was used in farming for 10 years and rented for 8, it would meet the test. However, if during the time period, it was used 80% of the time in a non-farming-related business and only 20% in the farming business, it would likely not meet the 50% test.

1994 $100,000 Capital Gains Election

In 1994, the $100,000 capital gains exemption for general property was eliminated. At that time, individuals were allowed to make an election to increase the adjusted cost base of their property by up to $100,000, but not exceeding the February 1994 value. If you made such an election on your qualified farm property, you are deemed to have disposed of the property and reacquired it in 1994. The result is, you must now meet the more difficult post-June 17, 1987, rules for qualified farm property on a future sale.

Splitting Capital Gains Between Spouses

If both spouses contributed to the purchase of property, they can split the gains to reduce taxes. Although both may be on title, it is the contribution toward the purchase that is the most critical. Generally, the capital gains from assets that are transferred to a spouse by way of gift attribute back to the spouse who transferred to asset. However the timing of the transfer is important.

Spouses added to title on or before December 31, 1971, would likely be able to split the capital gain. However, if they were added after that date, attribution rules would prevent splitting. The attribution rules do not apply on property that is sold to a spouse at fair market value. However, this must be a legitimate transaction with documentation and, where debt is involved, appropriate interest charged.

If the property is the asset of a spousal partnership, the capital gains will flow through to each partner based on their percentage ownership.

Table 2. Calculating a reserve

		Amount payable at end of:	
Proceeds of Sale	$500,000	Year of sale	$420,000
Selling Costs	20,000	Year 2	275,000
ACB	80,000	Year 3	175,000
		Year 4	75,000
Capital Gain	400,000	Year 5	0
Year of Sale		**Taxable Capital Gain in Year of Sale**	
The reserve is lesser of:		Total gain	400,000
420,000 x 400,000 = 336,000		Minus reserve	320,000
500,000		Capital gain in year of sale	80,000
Or 4/5 of capital gain = 320,000		**Taxable capital gain (1/2)**	**40,000**
Year 2		**Taxable Capital Gain**	
The reserve is lesser of:		Reserve from previous year	320,000
275,000 x 400,000 = 220,000		Minus year 2 reserve	220,000
500,000		Capital gain in year 2	100,000
Or 3/5 of capital gain = 240,000		**Taxable capital gain (1/2)**	**50,000**
Year 3		**Taxable Capital Gain**	
The reserve is lesser of:		Reserve from previous year	220,000
175,000 x 400,000 = 140,000		Minus year 3 reserve	140,000
500,000		Capital gain in year 3	80,000
Or 2/5 of capital gain = 160,000		**Taxable capital gain (1/2)**	**40,000**
Year 4		**Taxable Capital Gain**	
The reserve is lesser of:		Reserve from previous year	140,000
75,000 x 400,000 = 60,000		Minus year 4 reserve	60,000
500,000		Capital gain in year 4	80,000
Or 1/5 of capital gain = 80,000		**Taxable capital gain (1/2)**	**40,000**
Year 5		**Taxable Capital Gain**	
The reserve is lesser of:		Reserve from previous year	$60,000
0 x 400,000 = 0		Minus year 5 reserve	0
500,000		Capital gain in year 5	60,000
Or 0/5 of capital gain = 0		**Taxable capital gain (1/2)**	**$30,000**

Using a Reserve to Defer Capital Gains

What is a reserve?

A reserve allows for a deferral in reporting either business income or taxable capital gains. It is allowed when all or part of the proceeds of the sale are not payable until after the end of the year in which the property is sold. A reserve is also available for quota provided that an election under section 14(1.01) of the *Income Tax Act* is made.

Usually a mortgage or a note is sufficient evidence that an amount remains outstanding. However, care should be taken when using a note. A promissory note without restrictions as to when payment can be demanded represents "absolute payment" of the debt and in such a case, a reserve will not be allowed. The note should contain restrictions, such as payable 366 days after demand, to ensure that a reserve can be used.

A 5-year reserve is allowed on dispositions to unrelated parties. A minimum of at least 20% of the gain must be brought into income each year.

A 10-year reserve is allowed on the disposition of land, depreciable property, or a share in a family farm corporation or an interest in a family farm partnership to a child. Accordingly, a minimum of 10% of the gain must be brought into income each year.[8]

A reserve is not available to an individual who transfers property to a corporation that they control or did control or to a partnership in which they hold a majority interest.[9] A reserve is not available in the year of death.[10]

Why use a reserve?

There are several circumstances where a reserve might be useful. Firstly, if a large capital gain has been triggered, alternative minimum tax (AMT) may be payable even though the capital gains exemption is used. The use of a reserve could spread the gain over a number of years, reducing the possibility of paying AMT. As the capital gain is removed from the reserve, the capital gains exemption can be used.

The second circumstance is where the capital gains exemption is not available or has been fully used. Spreading the taxable capital gain over a number of taxation years may prevent income levels from reaching the higher tax brackets. It may also reduce the clawback of benefits and the possible application of the AMT.

How Is It calculated?

The amount available for a reserve is the lesser of two amounts:

- four-fifths of the gain in the year of sale (three-fifths, two-fifths, and one-fifth in years 2, 3 and 4)
- Amt payable at the end of the year divided by proceeds of the sale, multiplied by capital gain

Replacement Property[11] — Deferring Capital Gains

Capital gains and/or recapture can be deferred if replacement property is purchased. Replacement property is defined as "property acquired for the same or similar use."[12] The interpretation of this requirement is quite broad. In the case of farm property, a replacement property would generally qualify if it fell into the category of farming.[12] Also, the property must be used and not just acquired in order to qualify.

The length of time that you have to purchase the replacement property after disposing of the former property depends on the type of disposition. There are two types:

- an involuntary disposition, which includes property stolen, lost, destroyed or expropriated
- a voluntary sale of farm property

Where the disposition is voluntary, the property must be replaced within 12 months of the end of the taxation year in which the disposition took place. For example, if the taxation year end was Dec 31 and property was sold in January 2009, it must be replaced by the end of December 2010.

Where the disposition is involuntary, the property must be replaced within 24 months of the end of the taxation year in which the disposition took place.

The deferral can be applied to land, buildings and quota in either type of disposition. However, if the disposition is involuntary, then the deferral is allowed on all depreciable property, including machinery and equipment.

In both cases, an election must be filed in the year the replacement property is purchased. Taxes on recapture or capital gains from the sale of the former property are paid in the year the original property is sold. When replacement property is purchased, a reassessment is done and a refund issued. Table 3 shows an example calculation.

Replacement property can be purchased before the former property is sold. There is no time restriction on the sale of the former property. However, the election must still be filed.

At one time, Canada Revenue Agency (CRA) did not allow the replacement property rules to apply where an expansion of the farm business had occurred. For example, where a 200-acre farm sold for a high value and was replaced with 500 acres of less expensive land. CRA, however, has relaxed its interpretation on this issue and while it depends on the facts of each case, it appears that purchasing more land than was sold will not prevent the deferral from being available.

Table 3. Example of a sale and purchase of replacement property.

Property is sold for:	350,000
ACB	125,000
Selling costs	20,000
Capital gain	205,000
Replacement property	325,000

The capital gain you would report would be the lesser of the following two calculations:

Calculation

The actual capital gain	sale price	$350,000
	minus ACB	125,000
	minus selling costs	20,000
	Capital gain	**$205,000**

OR

The amount by which the sale of the old property exceeds the cost of purchasing the replacement.

Sale price	$350,000
minus selling costs of old property	20,000
minus replacement property cost	325,000
Gain on replacement property	**$5,000**

Here, $5,000 is reported as a capital gain. The difference of $200,000 ($205,000–$5,000) is deferred or rolled over. The ACB of the replacement property is reduced by the deferred amount, resulting in an ACB of $145,000 ($345,000–200,000).

While replacement property rules may not be used as much by individuals because of the $750,000 capital gains exemption, they are a useful tool for corporations, which do not have the capital gains exemption available to them.

A capital gain calculated using the replacement property rules can be offset by using a reserve.[14]

Principal Residence on the Farm[15]

Individuals are allowed an exemption on the capital gain of their principal residence. Farmers can use one of two options to calculate the gain on their principal residence.

- The house and half a hectare (approx. 1.2 acres) of land can be designated as your principal residence, which is then exempt from capital gains. More than half a hectare can be declared, but to qualify, it must be shown to be necessary for the use and enjoyment of the property. Also a reasonable allocation of the sale price between the house (including the half hectare) and the farmland must be made.
- The second method allows you to deduct, from the total capital gain on the entire property (house and farmland), $1,000 plus $1,000 for every year since 1971 that the house was the principal residence. Under this method, an allocation of the capital gain on the house and half a hectare does not have to be made.

The principal residence designation is limited to one per family unit, which usually includes spouses and children under 18. Where a farm has two houses, the principal residence designation can only apply to one house at a time.

The exemption only applies to the personal portion of a residence. Farmers who use a portion of their home as a farm office can claim reasonable expenses for that portion used as an office, however they should not claim capital cost allowance on the office portion since that could result in a loss of the principal residence exemption on the office portion of the house.[16]

Several other situations can arise on a farm.

- A house owned by a corporation is not considered a personal residence and therefore there is no principal residence exemption on the gain.
- A partnership cannot have a personal residence; however, a partner's share of the gain on a personal residence is exempt.

SECTION 3: SALE OF MACHINERY, EQUIPMENT AND BUILDINGS (depreciable capital property)

Depreciation is an economic term that describes the reduction in value of an asset because of usage. The tax term is capital cost allowance (CCA) and is an amount assigned by the *Income Tax Act*. For tax purposes, there are two ways in which the capital cost allowance can be calculated. The straight-line method can be used on assets purchased before 1972 (called Part XVII assets), and the declining balance method on all assets purchased after 1971 (called Part XI assets).

Machinery, Equipment and Buildings Purchased After 1971 (Part Xi Assets)

Part XI assets are grouped into classes, each of which has prescribed rates of capital cost allowance. The sum of all the additions, sales and deductions of CCA taken is called the undepreciated capital cost (UCC).

When depreciable capital property is sold, the lesser of either the sale price or the original cost of the asset is subtracted from the class.

A sale of an asset can result in recapture of capital cost allowance and/or capital gain, depending on the sale price.

Recapture of CCA occurs when the sale of the assets causes the UCC balance of the class to fall below zero (i.e., a negative balance is created in the class). In effect, this means that the assets have depreciated less than what has been claimed on your tax returns. Therefore, because you had previously claimed that amount as an expense, the difference must be "recaptured" and reported as income.

Capital gains can occur on buildings, machinery and equipment when their values have appreciated. The capital gain on buildings can be offset with the capital gains exemption, if available, however, machinery and equipment have no exemption for capital gains.

If you sell all the items in a class, you must keep track of the sale price of individual assets. This is because the proceeds must be allocated on an asset-by-asset basis in order to calculate the gain. To calculate the capital gain, you need to know the original cost of the items.

Table 4. Example of sale of Class 10 property

	Original Cost	Sale	Reduction of UCC in Class	UCC Balance Remaining	Capital Gain
Opening				**$150,000**	
Tractor 1	$75,000	$90,000	$75,000	75,000	$15,000
Tractor 2	105,000	65,000	65,000	10,000	0
Trailer	35,000	10,000	10,000	0	0
Wagon	35,000	18,000	18,000	– 18,000	0
Totals	**$250,000**	**$183,000**	**$168,000**	**– 18,000**	**$15,000**

In Table 4, the UCC is reduced by $168,000, causing the balance to fall $18,000 below zero ($150,000 – 168,000 = –18,000. The $18,000 is then added to income, along with 50% of the capital gain.

The calculation is as follows:

Taxable income = recapture + 50% capital gain

= $18,000 + ($15,000 x .50)

= $18,000 + $7,500

= $25,500

If you did not have records of the original cost of assets, you could potentially report the entire proceeds from the sale as a reduction in your UCC. This would result in $33,000 ($18,000 + $15,000) of fully taxable recapture, instead of part capital gains and part recapture.

Machinery, Equipment and Buildings Purchased Before 1972 (Part XVII)

Assets purchased before 1972 do not incur recapture but can produce a capital gain. While most of this machinery will be worn out, some well-maintained buildings or specialized equipment may produce a capital gain. It is important to keep them out of Part XI to avoid recapture.

SECTION 4: SALE OF MARKETING QUOTA

The tax rules for buying and selling quota are quite complex. If you are planning to sell a large portion of your quota holdings, be sure to review the tax implications with your accountant or tax advisor.

Depreciating (Amortizing) Quota and Your Cumulative Eligible Capital (CEC) Account

Quota is a type of property called Eligible Capital Property (ECP). Quota holdings are recorded in a special account called the Cumulative Eligible Capital account or CEC account. This CEC account keeps track of your quota additions, sales and the annual allowance or depreciation you take as an expense.

Three-quarters (75%) of a quota purchase is depreciable, at a rate of 7% annually. If you bought $100,000 of quota, $75,000 (75%) would be added to your cumulative eligible capital account, and depreciated at a rate of 7% per year, on a declining basis. The other quarter of your quota purchase is non-depreciable.

Although the term "depreciation" is most often used, "amortization" is the correct term to use when referring to eligible capital property. Many accountants now use this term in their financial statements.

Table 5. Cumulative Eligible Capital account

Year 1	
Purchase	$ 100,000
Depreciable amount added to CEC	$ 75,000
Depreciation expense for year 1	$ 5,250
Residual of CEC account	$ 69,750
Year 2	
Depreciation expense for year 2	$4,882.50
Residual of CEC account	$64,867.50

Selling Quota

The sale of quota can generate taxable income from two sources. The first is the recapture of depreciation taken. The second is the increase in value over the original purchase price. Often this is referred to as a capital gain, however technically this is not correct since only "capital property" can generate a "capital gain."

Recapture on quota sales is similar to that of buildings, machinery and equipment. Recapture occurs when the cumulative eligible capital account falls below zero. When this occurs, a portion of the sale is recapture and is added to your income. If the quota has appreciated, the increase in value would be income that may be eligible for the capital gains exemption.

The increase in the value of quota can be treated one of two ways. It can be called business income that is eligible for the capital gain exemption and as such is not subject to Alternate Minimum Tax (AMT). Alternatively, an election can be filed that deems the increase in the value of quota to be a capital gain similar to that on land or other non-depreciable capital property[17]. Filing this election can impact the sale of quota in three ways:

- AMT may be payable
- A capital gains reserve can be created for proceeds of the sale that are not due until a future year or fiscal period.
- Capital losses can be used to offset any capital gains on the quota[18]

A calculation should be done to determine which method is the most advantageous.

When quota is sold, the following calculations take place:

- The 1971 value of any quota owned before that date is deducted from the gross sale price.
- 75% of the remaining value is deducted from the CEC account. If, after this deduction, the CEC account is still positive, there is no recapture and no deemed capital gains. This positive amount could be deducted from income if all quota was sold, similar to a terminal loss with depreciable property.
- If, after the deduction you have a negative balance, you must calculate the recapture and deemed taxable capital gain.
- Subtract the CEC account balance from the taxable portion of the sale (75% of the sale price after adjusting for pre-1971 quota).
- Subtract the total depreciation taken to date. This is recapture and will be added to your income.
- Subtract half of the depreciation taken prior to 1988. (see explanation below)
- The remaining amount should be adjusted downward by two-thirds to reflect the 50% capital gains inclusion rate.
- The resulting figure is considered additional farming income

Table 6 shows how the calculation is made.

Table 6. Example of milk quota sale

Information you need for the calculation	
1971 value	$20,000
CEC account balance	$30,000
Depreciation	
Pre-1988	$8,000
Post-1988	$12,000
Calculation	
Gross sale value	$350,000
Deduct 1971 value ($20,000)	$330,000
Taxable portion (75%)	$247,500
Deduct CEC ($30,000)	$217,500
Less recapture (total depreciation)	$20,000
Subtotal	**$197,500**
Less 50% of pre-1988 depreciation	$4,000
Equals	**$193,500**
Inclusion Rate Adjustment	
For quota sold in Fiscal Period Ending after Oct. 18, 2000, the inclusion rate is 50%, down from 75%, which means an adjustment of two-thirds.	
Two-thirds adjustment results in additional farming income of:	**$129,000**

In the example shown inTable 6, $20,000 of recapture is added to the farm income, plus the appropriate deemed taxable gain.

The $4,000 pre-1988 depreciation adjustment occurs because in 1988, the capital gains inclusion rate was raised from 50% to 75%. Eligible Capital Property accounts were adjusted by 50% to account for the change in the amount of quota that was now eligible to be depreciated.

Depreciation taken before 1988, however, was not recalculated, so an adjustment is required at the time of sale to reduce the deemed taxable capital gain by half the pre-1988 depreciation. This is depreciation that is allowed under the post-1988 rules. In this example, the depreciation taken before 1988 is $8,000, so the adjustment is $4,000, which is subtracted from the deemed capital gain.

Ownership and Taxation of Quota

The amount of tax on a quota sale depends on how the quota is owned. For more detailed information on partnerships and corporations, see OMAFRA Factsheets *Farm Corporations*, Order No. 01-057, and *Farm Partnerships*, Order No. 02-047.

Ownership by individual or partnership

If the quota is sold by an individual or a partnership, the recaptured $20,000 is taxable income in the year the quota is sold, and taxed at the personal rate of the individual. The deemed capital gain qualifies for the capital gains exemption, which can be used if available.

Ownership by corporation

If a corporation sells the quota, three-quarters of the proceeds are subject to tax calculations. The recapture and capital gain is business income in the hands of the corporation, and is eligible for the small business tax rate. A large quota sale could push the corporation's net income above the small business corporate tax rate and into the higher corporate tax rate. A solution to that would be spreading the quota sale over a number of years if practical. The total amount of tax paid is dependent on the subsequent distribution of the sale proceeds to the shareholders.

SECTION 5: ALTERNATIVE MINIMUM TAX

Alternative Minimum Tax[19] (AMT) is a tax on dividends from Canadian corporations and capital gains. The AMT calculation is an alternative calculation of taxable income that includes the non-taxable part of the capital gain. The calculation shown in Table 7 uses the approach outlined in the Act, which includes a four-fifths (80%) downward adjustment of the capital gain followed by the deduction of the taxable capital gain. A simplified approach is to include 30% for the entire gain (30% x $500,000 = $150,000).

The AMT allows an exemption of $40,000, which means that the AMT has no effect until a gain of more than $133,333 is realized[20]. This amount can also be higher when the personal credits are used in the calculation. This alternative calculation is then compared to the regular tax calculation and, if it is higher, the additional amount is payable.

Any minimum tax paid can be carried forward up to 7 years, and used as a credit against any tax payable in those years.

Ontario also has an AMT, which is 40.33% of the basic federal tax calculated under the AMT calculation.

Table 7. Alternative Minimum Tax calculation

	Regular Tax Calculation ($)	Minimum Tax Calculation ($)
Capital gain	500,000	
Taxable capital gain – 50%	250,000	
Amount of gain for AMT (.80 x 500,000)		400,000 [1]
Income included after capital gains exemption used	0	
Untaxed capital gain (400,000 – 250,000)	0	150,000
Plus farm income	50,000	50,000
Minus minimum tax exemption		40,000
Approx. taxable income	48,010	158,010
Approx. federal tax payable [2]	6,221	23,702
Approx. provincial tax payable, including Ontario surtax (Ontario AMT is 40.33% of federal AMT)	2,655	11,363
Total federal and provincial tax	8,876	35,065
Additional minimum tax payable [3]		26,189

[1] The calculation for the alternative minimum tax adjusts the capital gain downward by multiplying the gain by 0.80. This is done because of the capital gain inclusion rate change from 75% to 50%.

[2] To calculate the regular tax payable, the 2007 federal and provincial tax rates were used. Federal tax rates are 15% on the first $37,178, 22% on income between $37,178 and $74,357, 26% on income between $74,357 and $120,887 and 29% on income of $120,887 and over. To calculate the federal tax payable in the minimum tax calculation, the rate is a flat 15%. The Ontario provincial minimum tax rate is 40.33% of the federal minimum tax.

[3] Only the basic personal tax credit of $9,600 and the CPP credit have been used in this approximate calculation of federal and provincial tax payable, for the sake of simplicity. The use of other credits would further reduce the tax payable.

ENDNOTES

[1] *Income Tax Act*, Subsection 28(1)

[2] *Income Tax Act*, Section 29

[3] *Income Tax Act*, Subsection 28(1)

[4] *Income Tax Act*, Subsection 28(1)

[5] *Income Tax Act*, Subsection 110.6(2)

[6] *Income Tax Act*, Subsection 110.6(1)

[7] *Income Tax Act*, Subsection 110.6(1.3)

[8] *Income Tax Act*, Subsection 40(1.1)

[9] *Income Tax Act*, Subparagraph 40(2)(a)(ii)

[10] *Income Tax Act*, Paragraph 72(1)(c)

[11] *Income Tax Act*, Subsections 13(4), 14(6), 44(5)

[12] *Income Tax Act*, Paragraph 44(5)(a.1)

[13] IT 259R4 para. 18

[14] *Income Tax Act*, Subparagraph 44(1)(e)(iii)

[15] *Income Tax Act*, Paragraphs 40(2)(b) and (c)

[16] Interpretation Bulletin IT-120R6 para.32

[17] *Income Tax Act*, Subsection 14(1.01)

[18] The election is available only to recognize gains and not losses. It cannot be used to recognize a gain that can be sheltered by an exempt gains balance, which may have been created by the 1994 election available when the capital gain exemption for general property was repealed.

[19] *Income Tax Act*, Section 127.5

[20] The $133,333 times 4/5 equals $106,666. The taxable capital gain of $66,666 (133k x 0.5) is subtracted, leaving $40,000, which is the amount of the exemption.

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